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Supreme Court of the United States

OCTOBER TERM, 1963

MOHAWK LIQUEUR CORPORATION, *Petitioner*,

v.

UNITED STATES OF AMERICA, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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February 1964

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MOHAWK LIQUEUR CORPORATION, *Petitioner*,

v.

UNITED STATES OF AMERICA, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Sixth Circuit, entered on October 21, 1963, reversing a judgment in favor of petitioner on an action for refund of federal income taxes entered by the United States District Court for the Eastern District of Michigan.

OPINIONS BELOW

The opinion of the court of appeals (R. 43), dated October 21, 1963, is reported at 324 F.2d 241. It is reprinted in Appendix B to this petition (pp. 8a-13a, *infra*). The opinion of the district court (R. 18) is

reported at 200 F. Supp. 321 and is reprinted in Appendix A (pp. 1a-7a, *infra*).

JURISDICTION

The judgment of the court of appeals (R. 46) was entered on October 21, 1963. A timely-filed petition for rehearing was denied on December 2, 1963 (R. 73; p. 14a, *infra*). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

QUESTION PRESENTED

Whether the Commissioner of Internal Revenue may compel a taxpayer, who has properly elected to employ the "last-in-first-out" (LIFO) method of inventory valuation as established by the Internal Revenue Code, to "unfreeze" the original inventory cost and to increase such cost by the amount of taxes subsequently imposed on units of inventory—despite the statutory command that original inventory is to be set and remain "at cost" when the LIFO method of inventory valuation is used.

STATUTES INVOLVED

The statute principally involved is Section 22(d) of the Internal Revenue Code of 1939. Its provisions are carried forward in substantially identical form as Section 472 of the Internal Revenue Code of 1954. Section 22(d) provided in pertinent part:

> "(d) (1) A taxpayer may use the following method (whether or not such method has been prescribed under subsection (c)) in inventorying goods specified in the application required under paragraph (2):
>
> "(A) Inventory them at cost;

"(B) Treat those remaining on hand at the close of the taxable year as being: First, those included in the opening inventory of the taxable year (in order of acquisition) to the extent thereof, and second, those acquired in the taxable year; and

"(C) Treat those included in the opening inventory of the taxable year in which such method is first used as having been acquired at the same time and determine their cost by the average cost method.

* * * * *

"(3) The change to, and the use of, such method shall be in accordance with such regulations as the Commissioner, with the approval of the Secretary, may prescribe as necessary in order that the use of such method may clearly reflect income.

"(4) In determining income for the taxable year preceding the taxable year for which such method is first used, the closing inventory of such preceding year of the goods specified in such application shall be at cost."

Other relevant statutes, including Section 472 of the 1954 Code, and the relevant Treasury Regulations thereunder are set out in Appendix E hereto (pp. 19a-28a, *infra*).

STATEMENT

Petitioner is a manufacturer of liqueurs and other alcoholic beverages. Beginning in 1942 and continuing to the present time, petitioner, as permitted by the Internal Revenue Code, consistently used the "last-in-first-out" (LIFO) method of valuing its inventory of finished products and goods in process. The LIFO method is based on the assumption that a business

using inventories physically disposes of the inventoried units in the reverse order of their acquisition. The method was authorized by Congress for use by certain selected taxpayers in 1938, Revenue Act of 1938, ch. 289, § 22(d), 52 Stat. 459, and for taxpayers generally in 1939, Revenue Act of 1939, ch. 247, § 219 (a), 53 Stat. 877, amending Internal Revenue Code of 1939, ch. 2, § 22(d), 53 Stat. 11, when Section 22(d) was added to the Internal Revenue Code of 1939. The authorization continues unchanged in Section 472 of the Internal Revenue Code of 1954.

The purpose of the LIFO method is to match current expenses with current receipts so as to protect the taxpayer against being taxed on paper profits and to protect the Government against the avoidance of tax on paper losses that are attributable to inflation or deflation of the prices of replacement inventory items. During a period of changing prices such paper profits or losses can result in the following manner: For most producing and selling businesses the major business cost deducted from gross income to arrive at taxable income is the cost of goods sold. This cost is computed by adding to the value of inventory on the first day of the year (opening inventory) the value of goods purchased during the year and expenditures directly attributable to such goods and deducting from the resulting gross cost of goods purchased the value of the inventory at the close of the year (closing inventory). The larger the value of the closing inventory, the lower the cost of goods sold and consequently the greater the taxable income. In a period of rising prices the value of the closing inventory will be larger if it is assumed that the taxpayer sold his goods in the order of their acquisition, leaving the

higher-priced, most recent acquisitions in his year-end inventory. But under LIFO the value of the year-end inventory will be lower because of the assumption that it contains the lower-priced, earliest acquisitions. Conversely, when replacement prices are falling, LIFO prevents a taxpayer from taking paper losses by preventing an inordinately low closing inventory, which in turn would cause an economic overstatement of cost of goods sold.

Petitioner determined in 1942 to adopt the LIFO method. The facts, stipulated in the district court, show without dispute that petitioner was authorized by the Commissioner to adopt this method and qualified to adopt it and to employ it subsequently.[1] Petitioner calculated its opening inventory as of October 1, 1943, the beginning of the first fiscal year in which it used LIFO. As required by the revenue laws the opening inventory was valued at cost, which included a federal excise tax of $4 per proof gallon then being levied on distilled spirits.

Effective November 1, 1942, one month after petitioner adopted the LIFO method, the excise tax on distilled spirits was increased by $2 per proof gallon; on April 1, 1944, that tax was increased by an additional $3, and on November 1, 1951, by yet an additional $1.50. In general, the excise tax on distilled spirits is payable when the spirits are produced or withdrawn from bond. On each occasion that the excise tax was increased the Congress imposed a so-called floor stocks tax, in the amount of the excise tax increase, on distilled spirits that had been withdrawn from bond and were being held for sale or other dis-

[1] The stipulation is at R. 12-17. The textual portion thereof is reproduced as Appendix D to this petition, pp. 15a-18a, *infra*.

position.[2] The purpose of the floor stocks tax was, of course, to place distilled spirits withdrawn from bond but not yet sold for consumption on a parity with spirits still in bond or not yet produced.

Petitioner consistently treated its excise taxes for income tax purposes by including in the year of an increase the amount of both any such increase and any corresponding floor stocks taxes as costs of selling goods. If the closing inventory of a year included units acquired during the year, their valuation at cost included the amount of excise tax attributable to them, just as the units in the opening LIFO inventory were valued at a cost that included the excise tax that had been paid on them. Units carried forward to year-end inventory from the opening inventory of the year, however, were not revalued to reflect floor stocks taxes paid on them. On audit the Commissioner of Internal Revenue took the position that petitioner was required to make that revaluation in each year in which floor stocks taxes were paid. This recomputation of the historical LIFO cost would, of course, have the effect in each year of increasing the value of closing inventory, reducing the cost of goods sold and thus increasing taxable income. Proceeding on that basis the Commissioner assessed additional income and excess profits taxes against the petitioner for its fiscal years ending in 1943, 1944 and 1951.[3] Petitioner paid the assessments

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[2] The statutes raising the excise tax and imposing the floor stocks taxes are: Revenue Act of 1942, ch. 619, §§ 602(a), 602(d), 56 Stat. 970, 971; Revenue Act of 1943, ch. 63, §§ 302(a), 308(a), 58 Stat. 61, 67; Revenue Act of 1951, ch. 521, §§ 451(a), 451(e), 65 Stat. 524, 525. See Appendix E, pp. 21a-23a, *infra*.

[3] The deficiency for 1951 resulted from a decrease in the amount of the loss carryback from 1952. This latter was the year during which the Commissioner's adjustment with respect to the 1951 floor stock tax had its impact.

and, having failed to effect an administrative settlement, sued for a refund. The district court, concluding that the effect of what the Commissioner proposed doing "would be to require the taxpayer to abandon LIFO accounting as to the floor stocks taxes," gave judgment for petitioner. On appeal this judgment was reversed by the United States Court of Appeals for the Sixth Circuit and the petitioner's complaint was ordered dismissed.

REASONS FOR GRANTING THE WRIT

The court of appeals has decided an original question of substantial importance in the administration of the federal income tax law, a question that has not been but should be settled by this Court. That question is whether a taxpayer who elects and qualifies to use the LIFO method of inventory valuation can be required to revalue basic layer and accretion layer units in its year-end inventory by the amount of payments made currently for inventory maintenance expenses, specifically for personal property taxes in the form of a floor stocks tax.[4] The decision of the court of appeals that a taxpayer may be so required is plainly wrong, contrary not only to the very theory of LIFO accounting but also to the plain mandate of the Internal Revenue Code.

The decision below permits continual adjustments with respect to a vast range of expenses in LIFO in-

[4] For simplicity the matter was argued and treated in the courts below as involving a revaluation only of the petitioner's basic layer LIFO inventory. In fact, there was also revaluation of accretion layer goods (that is, goods added to the original inventory in later years) to reflect floor stocks taxes levied after their acquisition. The principle at issue is identical in its application to these additional "layers" of LIFO inventory.

ventories.[5] The broad reach of the decision of the court of appeals was made quite explicit: "If . . . costs [subsequently incurred] are properly attributable to the goods on hand they ought to be reflected in the closing inventory irrespective of whether Lifo, Fifo or any other method is used." In addition to the floor stocks taxes that are involved here, this holding obviously applies to State and local personal property and similar taxes, storage expenses, insurance and, in sum, any other costs that can be attributed to the goods on hand."

At the outset it should be noted that the decision below is indisputably contrary to the unanimous view of accounting experts who have written on the LIFO method. These authorities, without dissent, state that —once priced for inventory purposes—goods that remain in inventory pursuant to the LIFO method of valuation do so at the historical price originally fixed for them, which cannot be changed. That precept, indeed, is at the heart of the LIFO method. See, *e.g.*, BUTTERS, EFFECT OF TAXATION: INVENTORY ACCOUNTING AND POLICIES 75, 79, 83 (1949); AMERICAN INSTITUTE OF ACCOUNTANTS, ACCOUNTING RESEARCH BULLETIN NO. 43, at 28-29, 34 (1953); Blough (ed.), *Current Accounting and Auditing Problems*, 93 J. ACCOUNTANCY 600-601 (May 1952); DOMINION ASS'N OF CHARTERED ACCOUNTANTS, CANADIAN RESEARCH BUL.

[5] Even if the decision of the court of appeals is confined solely to floor stocks taxes, such expenses, as can be seen from § 4226 of the Internal Revenue Code of 1954, are a common occurrence for a very large number of varied taxpayers. The adjustments which would be required by a uniform application of the holding of the court of appeals would affect thousands of taxpayers and would doubtless involve many millions of dollars.

LETIN No. 5, in 91 J. ACCOUNTANCY 141, 142 (January 1951); Lasser in ENCYCLOPEDIA OF TAX PROCEDURE 290-91 (1956); Peloubet, *Has Lifo Fallen?*, 85 J. ACCOUNTANCY 298 (April 1948); Tannenbaum, *The Lifo Method*, 25 TAXES 492 (1947); Welsch, *Lifo Method of Inventory Valuation*, 30 TAXES 343, 344 (1952).

Most importantly, the decision of the court of appeals on this seminal question is contrary to the governing statute; Section 22(d) of the Internal Revenue Code of 1939, re-enacted and in effect without substantive change as Section 472 of the current Code. By Section 22(d)(1) taxpayers were authorized, upon application, to inventory goods specified in such application in the following manner:

> (a) inventory the goods at cost;
>
> (b) treat the goods remaining on hand at the end of a taxable year as, *first*, the goods in the opening inventory of that year in the order of their acquisition to the extent thereof and, *second*, the goods acquired during the taxable year, and
>
> (c) treat the goods included in the opening inventory of the taxable year in which the LIFO method is first used as having been acquired at the same time and determine their unit cost by averaging their aggregate cost.

Section 22(d) of the 1939 Code was, and Section 472 of the 1954 Code is a complete, self-contained statutory sanction for a particular method of inventory

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[6] Taxpayers had options in determining what units acquired during the taxable year should be treated as included in year-end inventory. Treas. Reg. 118, § 39.22(d)-2(d); Treas. Reg. 111, § 29.22(d)-2(d); Treas. Reg. 103, § 19.22(d)-2(d). Since the relevant portions of Parts 103 (1939-1941) and 118 (1952-1953) of the Treasury Regulations are the same in all significant respects as Part 111, only the latter will be cited hereafter.

valuation. Section 22(c) of the 1939 Code provided, as had its predecessor statutes for many years,[7] and as Section 471 of the 1954 Code still does, that whenever the Commissioner found the use of inventories necessary to determine clearly the income of a taxpayer, inventories should be employed on a basis prescribed by the Commissioner. In pointed contrast, Section 22(d)(1) expressly provided that a taxpayer could use the LIFO method "whether or not such method has been prescribed under" Section 22(c). The Commissioner was thus divested of any power he might have had under Section 22(c) to deny the right to use the LIFO method to any taxpayer that otherwise qualified.

Petitioner followed the statute and regulations precisely and consistently in changing to and employing the LIFO method over the years in question. When it converted to LIFO beginning with its 1942-43 fiscal year it established its opening inventory by averaging the cost of the units on hand. Included in the opening inventory cost was the $4 federal excise tax on distilled spirits then applicable.[8] Treatment of excise taxes on goods as an element of their cost of acquisition in valuing them for inventory was and is an acceptable practice.[8] The practice had been followed by petitioner in previous years in which it had used the customary first-in-first-out (FIFO) inventory valua-

[7] See Revenue Act of 1938, ch. 289, § 22(c), 52 Stat. 459; Revenue Act of 1936, ch. 690, § 22(c), 49 Stat. 1658; Revenue Act of 1934, ch. 277, § 22(c), 48 Stat. 688; Revenue Act of 1932, ch. 209, § 22(c), 47 Stat. 179; Revenue Act of 1928, ch. 852, § 22(c), 45 Stat. 799; Revenue Act of 1926, ch. 27, § 205, 44 Stat. 16; Revenue Act of 1924, ch. 234, § 205, 43 Stat. 260; Revenue Act of 1921, ch. 136, § 203, 42 Stat. 231; Revenue Act of 1918, ch. 18, § 203, 40 Stat. 1060 (1919).

[8] The then applicable regulation was Treas. Reg. 111, § 29.23(c)-2.

tion method.[8] This consistent practice continued through all the years in question. Excise taxes paid, including in years in which the excise tax on distilled spirits was increased the amount of the increase, were of course reflected in the cost of any new replacement units that entered the closing inventory of that year. But, in obedience to the statute, to the theory of LIFO accounting and to the taxpayer's consisent prior practice, inventory units were not revalued to reflect floor stocks taxes imposed after their acquisition. Nor were they revalued to reflect personal property and similar taxes assessed and collected on goods on hand; nor to reflect storage expenses; nor insurance costs; nor any current cost of maintaining goods in inventory that was included—like the floor stocks tax—in the current cost of goods sold and not charged to inventory.

The district court correctly reasoned that Section 22(d) did not permit adjustments to the value of units of LIFO inventory for any such subsequently incurred costs. The district court pointed out that, even were one to resort to Section 22(c) for a guide to the meaning of the statutory word "cost," the regulations under Section 22(c) defined cost, in the case of goods on hand at the beginning of the taxable year, as the inventory price of such goods.[9] The court concluded:

> "[T]he 'cost' of 'those included in the opening inventory' is taken as the 'inventory price.' This, in turn, could only be the 'price' assigned to the goods for the preceding closing inventory, which was, in turn, calculated in the same way. This successive reference back is the heart of the LIFO method. Since 'cost' for each year is the same as

[8] The applicable regulation required that the actual aggregate cost of the goods making up the initial LIFO inventory "be determined pursuant to the inventory method employed by the taxpayer under the regulations applicable to the preceding taxable year." Treas. Reg. 111, § 29.22(d)-2(c).

[9] Treas. Reg. 111, § 29.22(c)-3(l).

> 'inventory price,' which, in turn, is merely 'cost' from the preceding year, it necessarily implies that 'cost' (for goods considered as continuously in inventory) is constant once the goods have entered the inventory. We thus find the price of the goods to be the price assigned to them as cost of acquisition at the time acquired or the time when LIFO was first instituted." (App. p. 4a)

The decision of the court of appeals overturning this conclusion of the district court cannot be sustained on any narrow ground that would leave undisturbed the LIFO accounting of other taxpayers for expenses other than floor stocks taxes. The court of appeals did say that the Commissioner was merely requiring petitioner to be consistent. The inconsistency the court thought it saw in petitioner's own tax accounting lay in the fact that the original LIFO valuation included excise taxes and floor stocks taxes previously paid on the goods in question,[11] while, as we have

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[11] The stipulation on which this case was tried stated that "as of October 1, 1942, when plaintiff determined opening inventory at cost, the excise tax on distilled spirits, as provided by the Internal Revenue Code of 1939, was $4.00 per proof gallon, and this amount was included by plaintiff in determining its cost of finished products and distilled spirits, exclusive of distilled spirits in bond, as comprising its opening inventory as of October 1, 1942." (App. p. 16a) The excise tax on distilled spirits had been increased from $2 to $4 in two stages, on July 1, 1940, and October 1, 1941. Revenue Act of 1940, ch. 419, § 213(a), 54 Stat. 524; Revenue Act of 1941, ch. 412, § 533(a), 55 Stat. 708. Both times that the excise tax was increased a floor stocks tax equal to the increase was imposed. Revenue Act of 1940, ch. 419, § 213(a), 54 Stat. 524; Revenue Act of 1941, ch. 412, § 533(d), 55 Stat. 708. The stipulation does not state whether there were goods in the October 1, 1942, inventory on which not the full amount of the $4 excise tax but a smaller excise tax and the equalizing floor stocks tax had been paid. As we shall show in the text, the point is of no consequence despite the emphasis laid by the court of appeals in its opinion and in its order denying rehearing on the asserted fact that floor stocks taxes were included in the cost of goods in the 1942 opening inventory.

noted, subsequent floor stocks taxes were not added to the inventory price of units already in inventory at the time they were imposed. There is no inconsistency. A going business converting to the LIFO method of inventory valuation must construct an inventory with which to open the first taxable year in which the method is used. The statute states generally how this is to be done. The statute requires inventorying at cost, and it is necessary to include as elements of the "cost" of acquiring the goods and placing them in the new LIFO inventory all expenses theretofore incurred that are directly attributable to the goods. Those expenses certainly would comprehend floor stocks taxes laid on the goods before they were placed in the opening inventory. Thereafter, if additional units are placed in inventory, creating new "layers" of LIFO inventory, they are assigned a value equal to the cost of their acquisition, which may or may not include the amount of any floor stocks tax imposed during the taxable year, depending on when they were acquired. But once goods are in inventory their value is frozen. Storage costs, state and local personal property taxes, floor stocks taxes and other maintenance expenses in subsequent years are treated as expenses of manufacturing and selling goods, not as adjustments to inventory prices.

There is a similar lack of substance to a suggestion made below by the Government that floor stocks taxes warrant special treatment because they are somehow additions to excise taxes long since paid. It is quite true that the purpose of the floor stocks taxes is to equalize the tax burden on all beverages not yet sold. But this does not mean that they appropriately can be considered as additions to a tax that may have been

paid many years before—and on goods that only because of the LIFO fiction are considered still to be on hand. The Government could better argue that a lump-sum retroactive wage increase covering a past taxable year should be added to the inventory price of finished products into which the labor in question entered. The readily admitted fact that floor stocks taxes are designed by the Congress to equalize prices among competitors on goods physically on hand certainly does not suggest that the design was also to amend Section 22(d) to require that the prices of goods only fictionally on hand be adjusted between the taxpayer and the Commissioner. The truth, as demonstrated above, is that such a taxpayer-Commissioner price adjustment would violate the most basic pre-supposition of LIFO inventory valuation—that the historical LIFO cost (based originally on the several expenditures necessary to acquire the basic layer goods and place them in the inventory), once properly established, is frozen and is not to be disturbed.

The effect of the adjustments exacted by the Commissioner and sanctioned by the court of appeals is that—at least with respect to floor stocks taxes and, if this new adjustment is to be consistently applied, with respect to all other inventory maintenance costs—all taxpayers that formerly used the LIFO method are now to be placed on a current-cost method of inventory accounting. For illustration, let it be assumed that a certain number of units had remained undisturbed in the basic layer of LIFO inventory from 1942 through 1952 with a 1942 unit cost of $2, exclusive of the prevailing excise and floor stocks taxes of $4. Under the LIFO method, as known until the court of appeals wrote, the 1952 opening inventory

unit price would be $6. But under the new view now advanced, the 1953 opening inventory unit price is to be $12.50. No units are to be carried at a value lower than the most recent per unit cost of all excise and floor stocks taxes. This is not LIFO inventorying. It is even more extreme than FIFO accounting, which at least requires unit turn-over before the value of inventory units is increased to current prices.

The decision below unquestionably poses the question to which the court below gave an affirmative answer—whether "costs subsequently incurred . . . properly attributable to the goods on hand . . . ought to be reflected in the closing inventory. . . ." The court of appeals' answer, if allowed to be the final answer, would have a drastic effect; an effect, indeed, that would totally frustrate the Congressional purpose in authorizing taxpayer use of the LIFO method. Certainly, the question thus raised cannot be dismissed as one that is not important in the administration of the taxing statutes.

CONCLUSION

For the foregoing reasons the petition for certiorari should be granted.

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